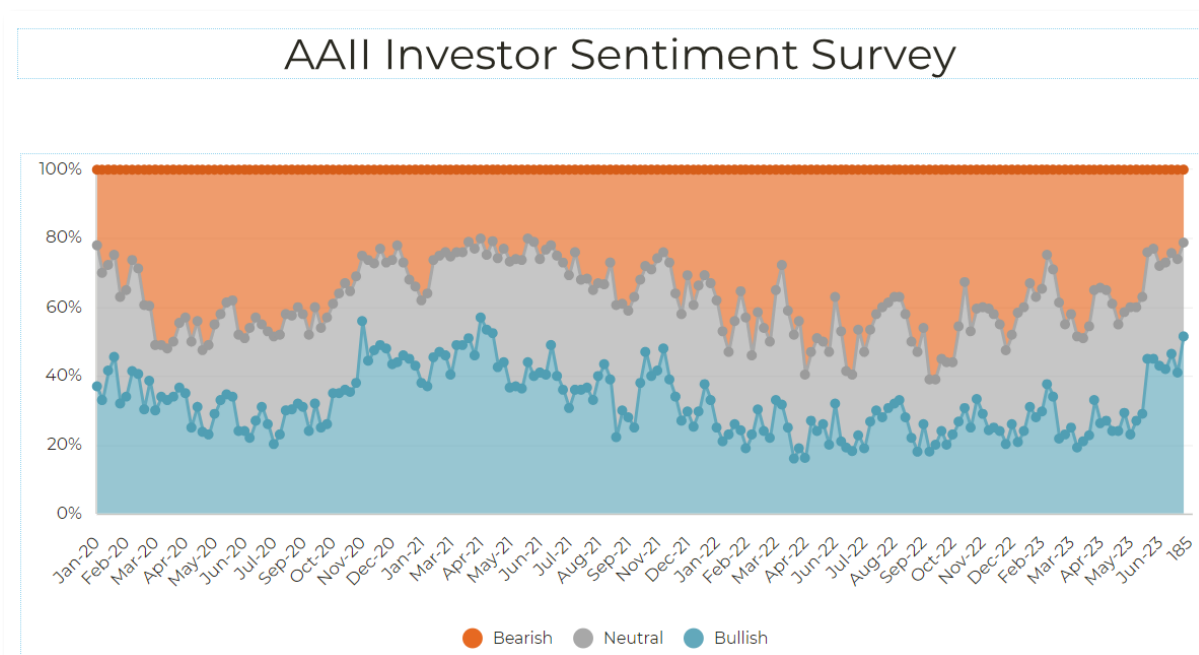


Dear Investors and Partners,

Hope you and your family are staying safe and healthy.

Last year, around this time, the sentiment was very negative. We had highlighted in the June 2022 newsletter, the sentiment readings, the consumers' and the investors', were at multi-year lows. Since that time, there has been a marked shift in sentiment, as many of you would have observed in the equity market valuations over the last several months. The steep vertical run up in the valuations is a reflection of the sentiment pendulum swinging from one extreme to the other end, perhaps not to the extreme optimism just yet. Before talking about anything else, let's see where we are, sentimentally speaking.



Just for context, a bullish reading of 50% is a level to be on alert, but the danger zone has historically been above a reading of 65%. Again, in and of itself, just a positive sentiment reading doesn't mean that we are due for a correction. The bullish sentiment is also high when we are coming out of a long slump like in 2003 when it stayed at elevated levels for 10 months in a row and then we witnessed one of the wildest bull markets of recent times over the subsequent 4 years. The sentiment reading has to be tied to the underlying economy, whether it has started warming up or it has been performing well and has overheated.

The Demise of the Dollar theory has started going mainstream in the past few months from being a topic of discussion for conspiracy theorists. A lot has been written about the burgeoning US debt, the printing press that the country owns, the importance of petrodollar, but nothing has changed over the past 10-15 years, perhaps because the military might of the country was superlative and the hustling opponent trying to challenge the hegemony was almost always a weak military power. The unequal competition was never a real threat. For the first time, the opposing side has two large economies - one in GDP, military power and the other one in its energy reserves. Both have centralised decision-making and a strong will to regain the lost glory. They have been silently but actively accumulating gold over the last five years and reducing their reliance on the de-facto global reserve currency. And for the first time, there is a real pressure being felt by the superpower of the last century.

One very interesting book on the subject I came across is 'Principles for Dealing With The Changing World Order: Why Nations Succeed and Fail' by Ray Dalio. The book covers five centuries of the rise and fall of empires. An important thing that the book talks about is that whenever there is a shift of power from an existing superpower to a new one, the global reserve currency loses its value over a period of time. When that happens, that currency finds its way into all kinds of physical and financial assets inflating their value beyond justification. The riskier the asset, the bigger the balloon gets in that process. The shift of power is not an event and often takes many years or even decades, but it moves in step function. I am not sure where we are in the process but the conditions are ripe for the process to start and it is good to be aware of the possibility. I am not taking sides here. I don't have to. Facts have an uncanny ability to unravel themselves.

The last couple of years of investing has seen a lot of macroeconomic and geo-political factors driving the equity valuations; more than the underlying fundamentals of the companies and the swings have been sharp in both directions. Our investing community has a unique ability to become an expert on such issues, or at least pretend to, right from learning the right pronunciation of Yevgeny Prigozhin to knowing all about his relationships, power play and political alliances and giving a discourse about the same, in less time than he took in his march to Moscow.

Why am I talking about this? Just to tell you that we are not experts at macro-economic matters. We are not geo-political masterminds. Far from it, we try to understand simple factors that affect our companies. To the extent we can, we try to distil everything going around the world into relevant, actionable data points and cut the rest of the noise. As of now, the way we see it, the power struggle and the likely move from a unipolar world to a multi-polar one has three scenarios:

1. The existing superpower continues to maintain its leadership: In this scenario, the status quo is maintained. Valuations will continue to be driven by company fundamentals. Regular ups and downs will continue.
2. The opposition to the existing superpower is a credible challenger: As discussed above, it is emerging as a likely scenario and will play out at some point. Perhaps the change is already underway. Time will tell. If it has, what has happened in the last four months to the equity valuations was just a trailer of a steep rally that can happen over the subsequent few quarters/years, punctuated with healthy doses of corrections in between. Valuation will be driven more by liquidity in the near term, followed by periods of I don't knows. Old timers might struggle in the late stage of this phase, if it were to occur, as the disconnect between valuation and intrinsic worth of businesses widens beyond a reasonable level.
3. The long tail event of the deadly red nuclear button by one of the above actors: Anything I write about being prepared for this scenario will just be theoretical manure and I will skip that.

Coming to a more familiar territory of the Indian economy and the outlook of different sectors, the picture is not as complex.

- Real GDP growth estimates for the year are a little under 6%. GST collections are healthy with monthly GST collections crossing INR 1.4 lakh crores for 15 months in a row.
- WPI Inflation has moderated sharply and turned negative, driven by softening of commodity prices. CPI inflation has moderated but food inflation continues to be a sore point (why wouldn't it when tomatoes are competing with Tiffany's in consumer's wallet share!).
- IIP growth is in the mid-single digits, driven largely by construction and infrastructure that has been doing well for 6-8 months now. If this sustains, this can set the tone for a multi-year virtuous investment cycle. Consumer durables have been struggling though during this phase.

- Banks, both public and private, have much cleaner balance sheets in over a decade. When stalwarts like Aditya Puri, Uday Kotak and Deepak Parekh are calling it a 'sweetest credit cycle in a long time', it is time to take notice. Personal credit growth has been clocking ~20% growth consistently.
- Chemical companies are facing sharp price corrections because of the restart of the Chinese exports.
- Agriculture-dependent companies are facing issues of excess inventory across the globe. A sharp correction in commodity prices is partly the reason for this. A normal monsoon can set things in motion for the domestic agri-business and the rural economy.

In a nutshell, there are some challenges but, on the balance, the economy looks to be heading in a positive direction. This explains why the country has been able to attract \$18 billion of FPI inflows in the last four months, the moment monetary tightening fears eased globally.

Given this backdrop, whether it is scenario one or two (of the geo-political dynamics) in play, our action plan for the time being remains the same.

Thoughts on Discounted Cash Flow analysis

I have been asked at different points if we do Discounted Cash Flow analysis of the companies that we invest in. Let me share my thoughts about the same.

DCF is a very good tool for sanity check of assumptions. It helps compare businesses across industries. It focuses on the right metrics - cash generation potential of the business. It takes a long-term view of how the business is likely to shape up. More importantly, it is a good tool for bringing in sell discipline; otherwise, it is very easy to get carried away.

But, and there is a big but, DCF is just a tool and it is just as good or as bad as the assumptions. One can easily play around with so many assumptions (terminal rate of growth, cost of capital etc.) that look innocuous enough to tweak but can change the outcome completely. I think, and some might disagree, it is tool to justify a decision that has already been made by other factors or actors. It is nothing more than a validation tool to convince oneself or others that the decision already made is mathematically sound. Moreover, it makes for a very good marketing tool - a model with 200 rows and half a dozen sheets looks like a lot of detailed work.

I think most screaming buys don't need this kind of convincing. Personally, I have made most of my wealth investing in stocks where I did not even have a financial model at the start or had a very basic one. If the business quality and back of the envelope calculations don't scream a 'buy' at you, then no amount of spreadsheet modelling will do that. I know of a very well reputed international investing firm that gave elaborate, mathematically eloquent justifications (of course, post-facto) of the fall in valuations in 2022 as a result of higher inflation with pin point accuracy using DCF model assumptions. I fail to understand how a business can be valued at 100 at one point, at 20 three months forward and at 50 eight months forward, and all three numbers correctly assess the intrinsic value of the business when the underlying business has not changed materially. The irony is that when a lot of people start believing this mathematical possibility, it starts playing out that way because their actions determine the demand and supply in the market. My limited point is that the market was irrational at least at one point and no amount of mathematical jugglery can prove one right. Do you compute and adjust and readjust the worth of the house you live in Bangalore, Mumbai, Delhi or Jaipur every time the US Department of Labour or the RBI publishes its monthly inflation data?

I am not against DCF analysis. We also do DCF analysis where the business is expecting significant transformation over the next few years, but it is a tool that is to be handled with care, otherwise it can just become a garbage-in, garbage-out tool and, in the process, give a sense of complacency.

Portfolio Update

We made an investment in a private bank. The opportunity was suggested to me by my ex-colleague around four years ago. We have been tracking the developments of the bank since.

This is a story of a couple of angry young men. One of them was very smart, very aggressive. He was the protégé of one of the most well-known faces of the Indian retail banking revolution. He built the retail banking business of one of the largest private banks. He is credited to have transitioned the nature of the bank from a project lending bank to a consumer bank. However, aggression, particularly in a lending business, is not a good thing. It can lead to survival issues in a leveraged business. Some people say that the scary situation that ICICI Bank reached in the Great Financial Crisis of 2008, was partly because of his aggression. It might be true. Then why are we invested in the bank that he is leading now?

There have been two changes over the last 15 years:

- He has mellowed down a bit. I am not suggesting that he is not aggressive anymore, he still is. But over the last decade, he has successfully built an institution and his actions have been focused on reducing balance sheet risk. The merger with a bank to create a strong liability franchise entity was a case in the point.
- He has directed that aggression on the liabilities side from the asset side and that has done wonders for the bank. Aggression on the asset side of the bank (distributing loans by lowering underwriting standards) can shorten the life expectancy of the bank while aggression on the liabilities side (building low-cost granular deposit base) can increase longevity and provides resilience in tough times.

How was the bank formed?

The bank in its current structure was formed as a result of a merger between a wholesale lending bank and a consumer-focused Non-Banking Financial Company (NBFC) where most of the current top management team has come from. The current Managing Director of the bank started and ran the NBFC for about a decade. The NBFC was majority owned by a private equity with incentives aligned with the management team. One of the key advantages of merging with a bank is the ability to raise low-cost consumer deposits to fund growth. This was one of the main reasons for the NBFC to merge with the erstwhile bank. However, it came with its own set of challenges:

- The erstwhile bank was largely dependent on infrastructure financing business. Margin on that business is paper thin and the business is susceptible to high cyclical credit costs.
- Since the margin is low, the bank had limited ability to invest in branches. Without consumer branches, the liability franchise was poor.

Since the merger, over the last five years, the current management has completely transformed the bank. It required significant changes both on the asset side and the liability side. The fact that it has been more or less fully achieved in less than five years required a lot of tough calls and is commendable, especially when the financial industry has seen multiple headwinds in the last 5 years starting with NBFC crisis in 2018

to multiple rounds of Covid driven spikes in credit cost. There were multiple goals but most of them revolved around two things:

- Fix the asset side of the balance sheet. Reduce the low margin infrastructure financing and replace it with a granular, higher margin consumer financing business.
- Fix the liability side. Replace the existing high-cost wholesale borrowings with lower cost retail deposits. This was a tall task when the bank had a limited retail presence.

Once you fix the above two, margins go up, credit cost goes down, quality of earnings improve and profitability is more sustainable. It seems easy on paper but is quite difficult in practice and I have seen many banks making strategy roadmaps and presentations for ten years in a row to achieve the above goals.

The progress on the above parameters has been very encouraging. The table shows the level of transformation:

Metrics	2018	Now
Liabilities		
Number of branches	200	800
Retail deposits	27%	76%
CASA ratio (Current Account and Savings Account as a percentage of deposits)	9%	50%
Assets		
Infrastructure financing book	37%	3%
Retail finance	35%	79%
Top 20 borrowers (Concentration)	16%	7%
Top 5 industry exposure (Concentration)	41%	22%
Profitability		
Cost to Income	95%	72%
Core profitability (pre-provisioning operating profit)	0.32%	2.10%
Return on asset	0.64%	1.40%

While a lot has been achieved, rationalising the cost structure is still in 'Work-in-Progress' stage. Increasing a branch network 4x does have cost implications and the same is likely to yield benefits in the years ahead. Costs are also elevated because of the upfront investment in some of the businesses that the bank is seeding. The credit card business is one such investment. It is a loss-making business for the bank right now. From having no presence in the credit card segment less than three years ago, it has now reached the top 10 credit card issuers in the country. The good thing is this is a largely directly sourced business which keeps credit costs in control. As the business matures, it is expected to become profitable and improve the return profile of the bank further.

While we have trimmed our exposure in the bank after the steep run up in valuation, we continue to like the business quality and at the right valuation, we will consider increasing the holding again.

I mentioned 'angry young men' in the beginning. Well, the other one was not in the same company but in a competing banking behemoth; his next-door neighbour, so to say. Similar story, similar structure but it is

somewhat under the radar at this point. He is less aggressive, but only slightly. He thinks and plans in 7-year cycles. He is focused on building the bank for the long term but is smart enough not to compromise a lot on the near-term profitability. We like the owner-manager combination. We are invested in that bank as well, but that is a story for another day.

We thank you again for your trust. Please feel free to reach out to us, should you have any suggestions, questions or feedback.

Best regards,



Parag Jhawar

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